RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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LETTER 1333

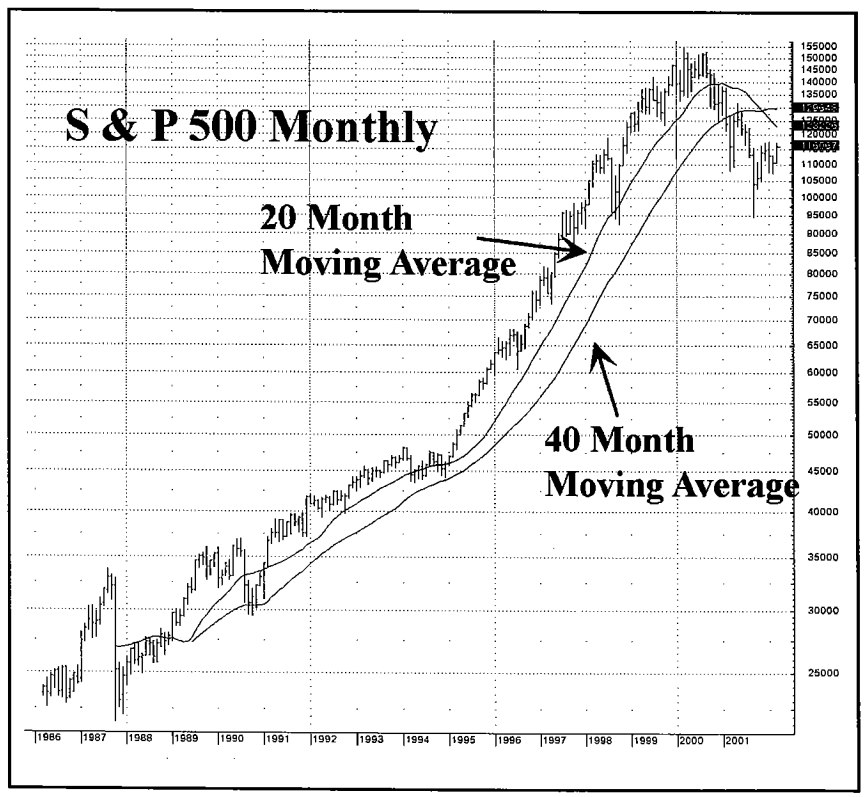
Mar. 8, DJIA 10586.82; PTI 5337; AD Ratio +2.15
Mar.15, DJIA, 10607.23; PTI 5340; AD Ratio +2.40
Mar.22, DJIA 10427.67; PTI 5334; AD Ratio +2.18
Dow yield: 1.76% Dow p/e: 28.18
Gold 50-day MA: 292

THE BIG PICTURE: I'm going to start this Letter with a very big picture, and it has to do with the action of the S&P 500 Composite. I first came upon this study via some comments by that excellent market analyst, Bernie Schaefer.

The chart on this page is a monthly chart of the S&P going back to 1986. I have superimposed two long-term moving averages of the S&P, the longer and slower moving is a 40-month moving average. The second is a faster-moving 20-month moving average of the S &P. My chart doesn't go back that far, but the shorter or 20-month moving average first crossed above the 40-month MA back on May 1980, or 22 years ago.

In September 1982 the 20-month MA came down to touch the 40-month MA, but it did not penetrate the 40-month MA. Again in June of 1989 the 20-month MA declined to touch the 40-month MA, but again the 20-month MA failed to close below the 40-month MA.

The 20-month MA continued to climb, always holding above the longer 40-month MA. Then something occurred which changed the entire technical situation. In January 2001 the 20-month MA turned down. It has continued down since that time.



In December 2001, a second technical milestone was reached. In December of 2001 the 20-month MA crossed decisively below the 40-month MA – this for the first time in 22 years. The 20-month MA has remained below the 40 month MA since that time.

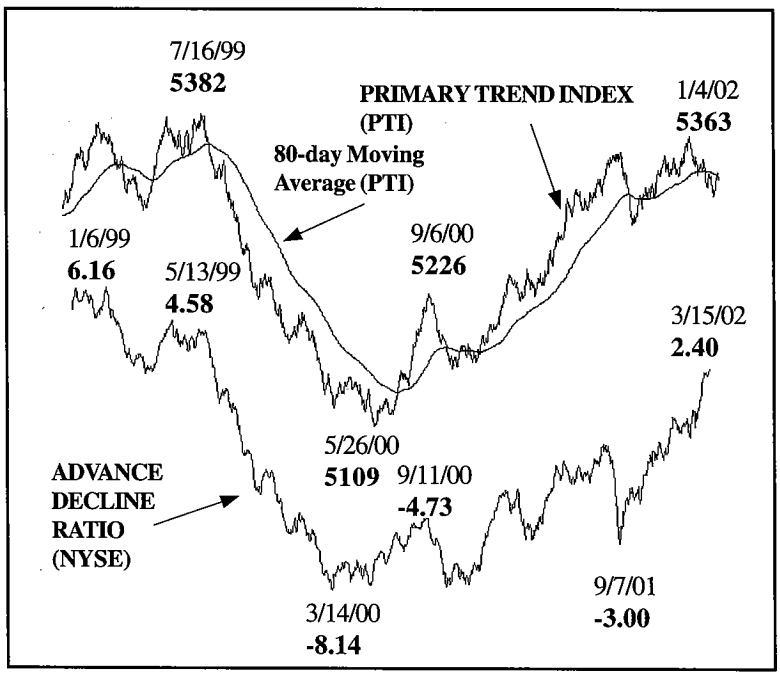
The crossing of the 20-month MA below the 40-month MA after 22 years, in my opinion signals that a **major top is in place**.

I believe that the 20-month MA will offer strong resistance to any rally from here. The 20-month MA now stands at 1232 on the S&P.

Aside from the moving averages, note that the monthly S&P has taken the form of a giant head-and-shoulders top. The "neckline" or major support for this formation comes in at 950. Anything below 950 on the S&P should see the beginning of a "waterfall" decline.

What about the **Dow** in relation to its own 20-month and 40-month moving averages? The 20-month MA of the Dow first crossed above the 40-month MA of the Dow in June of 1980. The 20-month MA of the Dow came down to touch, but not penetrate, the 40-month MA in September 1982 and again in June of 1989. From there the 20-month climbed until January 2001. In January 2001 the 20-month MA turned down. In January 2002 the 20-month MA broke below the 40-month MA with the Dow at 10330.

The Dow, the strongest of the major stock averages, has now climbed above both its 20-month and 40-month MAs, even though the 20-month MA is below the 40-month MA. I would say that any decline by the Dow below 10316 would act as a major "sell signal."



THE TOP – A wise and very successful investor was asked, "What is the best way to make money?"

He answered immediately, "The best way to make money is not to lose it."

A cynical reply? Not at all, the fellow was absolutely serious. Money will tend to accumulate if you don't lose it.

The best way to lose money in a bear market is just to keep "playing around" with the stock market – buy something here, sell something there, take a tip, buy a highly-touted mutual fund, just keep fooling around. And in due time, sure as shootin', you'll lose your money.

Funny thing about a bear market. Once you start accumulating losses, you never seem to be able to get back to even again. The bear keeps whittling away at your assets. You try to make up those losses, and for some damnable reason, you just lock in additional losses. I don't think I've ever seen this process fail while the primary trend of the market is down.

I've discussed this on my daily site. And in observing this costly and frustrating process, I created my favorite bear market adage which runs like this –

"Everyone loses in the bear market, and the winner is the one who loses the least."

We've seen a parabolic rise in the major stock averages, rises that topped out during the 1999 to 2001 period. The tops coincided with bubbles in stocks. Why do I call them bubbles? I call them bubbles because at the peaks, stock

valuations rose to heights never seen before. Price/earnings ratios went off into space, dividend yields sank into the low 1% area,stocks sold on average at over six times book value, IPOs at issuance rocketed to ridiculous, unimaginable prices, and the public berated their brokers for not supplying them with the latest new issues.

So we had parabolic rises ending at bubble tops. Once these kinds of markets top out, you can be sure of one result. The stocks averages, in time, will regress to the mean. Actually, it would be an act of kindness if the stock averages only regresssed to the mean. The fact is that in the corrections following a bubble blow-off stocks almost always sink below the mean.

The mean for the S&P runs about 14.5 times earnings with average stock yields at around 4.5%. Should stocks return to that mean, we could expect the S&P to sell at roughly half its current value. But since a post-bubble stock market usually take stocks BELOW the mean, we can expect the S&P (before the bear market is over) to sink well below the mean.

By this September it will be three years since a primary bear market was signaled under Dow Theory. During those three years a lot of stocks have been hurt, a lot of bankruptcies have accumulated, and a lot of people have lost money. Nevertheless, I consider most of the action since September 1999 as a topping process for stocks. In fact, we may have constructed the greatest and most dramatic stock market top in history.

INVESTMENT POSITION: Suppose you had a bond portfolio, and you had established your initial position. Furthermore, you are going to add X amount of bonds to your bond portfolio every six months. **Question** – Would you prefer that interest rates were heading up or heading down?

Answer – You would do better if interest rates headed up. True, the value of your bond portfolio would sink in the face of rising rates, but as your bonds moved towards maturity they would rise towards maturity value or par.

But at the same time, since interest rates were rising, your semi-annual purchases of additional bonds would be paying increasingly higher returns. In the end, the advantages of compounding at higher rates would erase and then more than make up for the problem of declining prices in your overall bond portfolio.

This is one way of dealing with the situation if the market lapses into an extended trading range. In other words, if following the topping out of the stock market we lapse into a long period of trading range action, the question or problem of income will loom large. And stocks with no dividends (as is the case with so many stocks today) are not going to cut it.

Right now, because stocks have been down for the last two years, there's been a subtle drive for corporations to pay dividends. But at best, even if this works, it will take time. And corporations that pay no dividends today, are not going to start by paying attractive dividends. The dividend yield for corporations just starting to pay dividends will be slight.

Furthermore, many corporations will hesitate to pay dividends simply because dividends require real, honest-to-God earnings, and in a lot of cases corporate earnings have been accounting earnings, not real earnings. It takes actual, real earnings before a corporation can pay an actual, real, cash dividend.

Based on the current very high price/earnings ratio for stocks, buy-and-hold investors face a long, tedious period in which stocks may bring in a total return of 5 % or 7% or even less. Statistics tell us that when P/E on the S&P is 20 or above, the median annual total return for the coming decade will be around 5%. With the P/E over 43, you have to wonder what the median annual total return will be over the coming years.

All of this means that there is a lot of risk in investing at this time. The variables are many and they are extreme. On top of that there is the Achilles Heel of the entire picture and that's the dollar. We have to wonder how long, or how much longer, our foreign creditors will continue to accept American paper for their merchandise and hard labor. They've been accepting dollars for a long time, but the negative trade balance figures are unsustainable. With the new euro and perhaps bottoming Japanese yen as competition, common sense tells us that somewhere ahead the dollar will hit the trail to lower levels.

My own answer to what I see ahead is to compound. I've been compounding with municipal bonds and some dividend-paying utilities (SO, AEP, ED, NOR, TXU, DTE). So far it's worked. Over the last two years with stocks declining, top-grade bonds have provided a total return of 10.4% in 2000 and 6.7% in 2001. So far, so good.

NOTES & QUOTES: Before I forget, we now have fewer than 1,000 subscribers who are not on the Internet. May I urge you non-computer people, once more, to buy some sort of simple device that will get you on the Internet. I have subscribers in their 90s who are now on the net. And they love it.

Moreover, I do write six days a week, providing a run down on the market closing plus daily comments on the whole market picture. If you aren't getting on the daily site, you are missing valuable information – and it comes **free** with your subscription. Many subscribers tell me that they wouldn't miss the daily comments for anything, and that they would subscribe to the service for the daily sites alone.

So do yourself a favor. Go to your local computer store and check out what's available so that you can get on the Internet. You won't be sorry, believe me.

By the way, Dell Computer, the number one PC maker, sends catalogues to homes without computers to explain how computers can change people's lives.

Gateway will send a technician to set up a computer in a first-time buyer's home for about $100; hooking up the machine to the Internet costs $30 more. It's worth it. Access to the Internet gives you access to the knowledge of the world. For me, being without access to the Internet is comparable to living without newspapers, radio or TV.

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Does anything work in this market any longer? Richard Bernstein of Merrill Lynch has used what he calls his "Sell side indicator" to forecast what the market is likely to do. This indicator shows the percentage of stock allocations that 37 Wall Street strategists recommend.

When the percentage of stock allocations is over 50%, the outlook for stocks is not particularly good. When the percentage is over 60%, the year ahead for stocks should be a loser. But the latest reading is just off its highest level in the 21-year history of the data. The latest reading is just over 69.9. This calls for a 20% drop in stock prices over the year ahead.

But from what I hear, Bernstein has ignored his own indicator – he thinks stocks will be up 5% over the next year. However, Bernstein has another worry, which evidently he is ignoring. He's worried about the market's highest ever price/earnings ratio, currently at 41—this is based on the S&P's earnings over the past four quarters.

The 25-year average P/E is 17.05 while the 50-year average is 16.17. When the S&P's P/E has risen above 20.2 the market has lost 2.5% in the subsequent three months, 7.3% over six months and 1.4% over 12 months, according to Ned Davis Research. After two years stocks have been able to eke out a return of only 0.8%.

What about when the P/E for the S&P is over 43? Guess we'll find out.

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The eastern US is suffering from what is probably its worst drought in 100 years. Forest fires, usually smothered by snow, burn to the ground. The Potomac river has declined to historic lows. New England is experiencing one of its driest winters on record. Californians, long used to droughts, have learned how to conserve water. The east is going to have to learn how to do the same thing – conservation is the name of the game.

On top of the drought, heat is here. Last week the NOAA released evidence showing that the last three years were the three warmest on record for the entire US. For the planet as a whole, January 2002 was warmer than any January in 123 years. A report to President Bush noted that warming weather would have severe consequences for the nation's water resources.

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Here is what the latest life-expectancy of newborns look like in the US. White females 80.0 years. Black females 74.8 years. White males 74.5 years. Black males 67.6 years.

Here are the causes of death for men compared to women – Heart disease number one cause of death with men 1.8 compared with women. Cancer number 2 at 1.4. Stroke number 3 at 1.1. Pulmonary disease 1.4. Accident 2.4. Pneumonia and influenza 1.5. Diabetes 1.2. Suicide 4.3. Kidney disease 1.5. Liver disease and Cirrhosis 2.3. In almost every case men do worse than women.

Men are less likely to exercise, less likely to see a doctor, less likely to take vitamin supplements. Men are also less able to deal with stress or to show their emotions.

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They're killing the music business. Today you can go to Audio-galaxy.com and download whole CD box sets including the booklets and cover art free of charge in the form of Zip files. A few weeks ago Michael Greene was both cheered and booed for an onstage rant against digital file-sharing. How's this for a shocking statistic? Last year blank CDs actually outsold pre-recorded ones.

Two out of five music-consumers own a CD burner today. Roughly, the same number of people (kids) stated that they downloaded rather than paid for most of the music that they listened to last year. Furthermore, young people (who the industry depends on) spent more time on computers than they did at Tower records. Many music-loving kids have never bought a CD. No wonder the music business is trembling.

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The birth rate of the developed nations is dropping precariously, while the populations of the underdeveloped nations is booming. The "replacement" fertility rate needed for a population to remain stable is about 2.1. Here are the US birth rates by decades: 1960s it hit a high of 3.55; 1970s 2.48; 1980s 1.84; 1990s 2.08; 2000 2.10. The current 2.10 is largely due to the huge influx of Latinos plus the high birth rate of blacks — plus immigration. Birth rate for Hispanic mothers is 3.1.

And how's this for a change in morals – more than one-third of all US births are to unmarried mothers. When I was a kid, it was a scandal and a tragedy if an unmarried woman got pregnant. Today's it's almost totally accepted – even movie stars do it, and talk about it openly to their public.

Now check these fertility rates from other developed nations. Australia 1.77, France 1.75, UK 1.73, Belgium 1.61, Switzerland 1.47, Japan 1.41, Germany 1.38, Spain 1.15.

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Where to live? These states have no income tax, but many have high sales taxes or property taxes. The no-income tax states are Alaska, Delaware, Montana, New Hampshire, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming.

BestPlaces.net can give you a good idea of comparitive values. This site which carries no advertising and no fees allows you to compare 3,000 different cities. Me, I hate California's taxes and incompetent government, but I love the climate.

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The battle for or about options is on. Stock options give their holders the right to buy shares in the future at a specific price, typically at the price of the stock when the option was granted. If the share prices rise above the exercise price, an executive can use the options to buy the stocks and sell the shares immediately, pocketing the difference.

But unlike other forms of pay, options do not appear as an expense on a company's income statement. A change like a law now being proposed could reduce corporate earnings, over all, by almost 10%. A bipartisan group of five senators has proposed a bill that would effectively force a change, and an international accounting oversight group is also considering a rule to require a change. Greenspan publicly supported the change this month.

When converted into stock, options dilute the stake of existing stockholders. Many companies whose stocks have collapsed have repriced their options so that their option holders will have an almost guaranteed opportunity to gain at the sale of their options. The argument against the current system is that options are a form of compensation, and as such they should be treated like any other form of compensation and an expense to the corporations.

What do corporate insiders know? Well, supposedly they know what's happening in their own companies. H.D. Brous & Co. has computed insider transactions, and they note that since September 93% of shares transacted by insiders at the 50 largest companies were on the sell side. The figures – 3.2 million shares were purchased against 45.2 million shares that were sold.

LATE NOTES: Down about two miles south of here in Pacific Beach there is usually a gathering of vagrants. I've stopped to talk to some of these people, and I've marveled at the way they live. Many sleep during the day and stay awake most of the night. They stay awake at night because it can be dangerous to sleep on doorsteps or in the fields.

In other words, they are very used to what I consider a hard, loveless life. And I think — it's just incredible what people can get used to.

I tend to equate the vagrants' lives to what's now happening in the stock market. I grew up in an era where good stocks sold for 8 to 12 times earnings, while throwing off dividends of 5% to 10%. And look what we have now – the S&P selling at 44 times earnings and a 1.7% yield, while thousands of stocks pay no dividends at all. And people buy these stocks!

Why do they buy them? Because they are used to these prices – many grew up with these prices. But what the Dow Theory tells us is that "this will change." It will take time, but "this too will change." I guess it's really sad when you think about it. And I do think about it.

NEXT MAILING: April 17, 2002